

**COSTA RICA
POLICY TOOLS FOR RURAL FINANCE**

**FINANCIAL REFORMS IN THE CREDIT UNION SYSTEM
OF COSTA RICA**

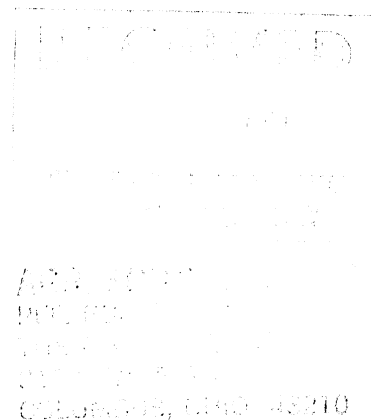
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Abstract

In 1989, the credit union system in Costa Rica is once again faced with a serious crisis of insolvency, after an impressive recovery from its crisis in 1980-1981. This paper outlines the major structural problems that confront the credit union movement in Costa Rica and that explain its current crisis. It is felt that if these structural problems are resolved, the future performance of the system can be significantly improved.

The first section presents a brief summary of the major events that led to the private financial markets crisis in 1987 and 1988 and discusses its impact on the credit union system. The second section focuses on the institutional weaknesses of the individual credit unions as financial intermediaries, and suggests important reforms to overcome them. Finally, the third section suggests the optimal design for the second level organizational structure for the credit unions, to address the major problems discussed here.

FINANCIAL REFORMS IN THE CREDIT UNION SYSTEM OF COSTA RICA

by

Rodrigo A. Chaves and Jeffrey Poyo*

I. Introduction

In 1989, the credit union system of Costa Rica has once again faced a serious crisis of insolvency, after an impressive recovery from its earlier crisis in 1980-1981. Both the individual credit unions as well as their second-level institution, Fedecredito, achieved an impressive growth of total assets and membership during the six years between 1982 and 1987, based upon voluntary deposit mobilization. Although the origins of the present crisis may be said to have begun outside the credit union system, since it has been in part a result of the failure of several non-regulated finance companies, which undermined depositor confidence in private financial intermediaries, it is no less evident that the administrative and financial fragility of the credit unions themselves contributed to this outcome, as well, by transforming what would have been a mild cold into a life-threatening bronchitis.

The credit unions are a very important component of the Costa Rican financial markets, not only because of the number of their members and the volume of their total assets, but also because they represent the only private financial institution with an important presence in the rural areas. Because they are mutualist institutions, in which the members are both the clients and the owners, the relatively small rural credit unions possess a comparative advantage in obtaining information for the evaluation of the creditworthiness of their clientele. Their costs are relatively low, when compared to

those of the nationalized or private banks, and because of their size, they impose lower transactions costs on their clients, as well. As a result of the recent growth and development of the credit union system, the rural population obtained greater access to formal financial markets. These important gains are presently in danger, given a crisis that threatens the financial viability of the system.

The objective of this paper is to outline the major structural problems that confront the credit unions system as a whole and that help explain why it has once again been overcome by a financial crisis, after a period of six years of rapid growth and development. It is felt that if these structural problems were resolved, the future stability of the system could be significantly improved. The structural problems analyzed in this paper may be grouped into three main categories: (1) microeconomic problems at the credit union level; (2) second-level political and financial organization issues; and (3) legal and regulatory framework requirements.

The first section presents a brief summary of the major events that led to a severe crisis in the private financial markets during 1987 and 1988, and an evolution of its impact on the credit union system. The second section explores the institutional weaknesses of the individual credit unions as financial intermediaries, and suggests major reforms needed to overcome them. The third section contains an outline of a second-level organizational structure which could address the major problems found therein. The last section discusses the political economy milieu of the credit union system, in order to identify opportunities of obstacles for the desired reform.

II. Crisis in the Private Financial Markets

The crisis in the private financial markets of Costa Rica had its origins in the insolvency of a series of non-regulated finance companies, which occurred throughout 1987 and the first quarter of 1988. A partial listing of the major events is provided below:

Financial scandal at the National Stock Exchange	October	1986
Autos Tibás e Inversiones El Sol failures	January	1987
Escalante y Asociados failure	June	1987
UNINSA failure	November	1987
COFIDESA (Orlando Sotela) failure	November	1987
Corporación de Inversiones Tico Americana, S.A. failure	November	1987
Financiera Serfec Consultores failure	December	1987
IBESA failure	January	1988
Crediticia arrangements	February	1988

The crisis began with the failure of a series of minor finance companies, which spread to others, as investors began to withdraw their funds in fear. With the unexpected increase in inflation and the growing wedge between the official and the black market exchange rates, the Central Bank carried out policies aimed at restricting the growth of the money supply. As a result, short-term interest rates rose, and the risk premium paid by the private sector grew significantly, because of the resulting panic. In the last quarter of 1987, the risk premium paid by the private sector over the public sector quadrupled, from approximately 1.4 percentage points to 5.6 percentage points per annum, because of investor lack of confidence in the private financial and non-financial institutions.¹

¹ See Jeffrey Poyo, "Crisis, Mercados Financieros Duales y la Estructura de Tasas de Interés en Costa Rica: 1985 - 1988," BOLSA, Bolsa Nacional de Valores, San José, Septiembre 1988.

This rise in interest rates created serious instability for many brokerage houses at the National Stock Exchange, since they had been taking significant interest rate risks through their investment strategy for money market funds. With the rise in short-term interest rates, and the massive withdrawal of funds by panic-stricken investors, some brokerage houses had to be bailed out by the National Stock Exchange, in order to avoid a financial debacle there. When the financial crisis finally led to the bankruptcy of the first regulated finance company (Crediticia), and deposit instability was even felt among the private commercial banks, the Central Bank finally intervened, by injecting additional liquidity into the market. The credit unions were not isolated from these problems of financial panic and between June 1987 and March 1988, their deposits were drawn down by 781 million colones (almost US\$10 million).

III. Structural Weaknesses of the Credit Union System

Between 1982 and 1987, the credit union system of Costa Rica experienced a very rapid rate of growth, based on a strategy of voluntary deposit mobilization, both from members and non-members. With a very aggressive interest rate policy, they were able to mobilize a significant volume of domestic savings. Their institutional and administrative development lagged far behind the growth in total assets, however, and as a result these institutions were incapable of weathering the financial crisis that confronted them at the beginning of the third quarter of 1987.

The very rapid growth in funds mobilized by the credit unions eventually began to outstrip the capacity of their traditional clientele to absorb loans. This took place because these institutions kept their deposit interest rates high, even when their local

investment opportunities were exhausted. They were thus pressured to find new profitable investments for the surplus funds they were generating and, as a result, they made serious errors in their asset-liability management decisions. These errors began with the race to construct their own buildings, financed with the deposits and shared mobilized from the public. This construction frenzy is made evident today by the unnecessarily large buildings which now house many of these institutions. The second major mistake was to diversify their services into non-financial activities, as they opened their own supermarkets, pharmacies, hardware stores, clothing stores, agricultural input stores and the like. Not only were the majority of these investments unprofitable, and had to be subsidized by the savings and loan department but, as in the case of the buildings, they also contributed to the serious imbalance in the term structure of their assets and liabilities.

In an effort to expand their loan portfolios, the credit unions began to make loans to non-members from outside their geographic region. Once the rural credit unions expanded beyond their geographic area of influence, they lost their informational comparative advantage, which in part had made up for their lack of banking expertise. In an effort to maximize the return on their liquid reserves, some of these institutions made highly speculative investments in non-regulated finance companies, as well, attracted by the very high deposit rates of interest offered there. These very high rates were a reflection, however, of the moral hazard problems that permeated some finance companies.

Beginning in the first quarter of 1987, the credit unions were confronted with an unusually high withdrawal of deposits and of shares on the part of their member and

non-member depositors. This unexpected withdrawal of deposits added to their financial mistakes and made the quality and liquidity of their asset base insufficient to respond to the demand for withdrawals. In fairness it must be pointed out, nevertheless, that other private financial institutions with much stronger management capabilities and asset quality could not confront this massive withdrawal of deposits, as was the case of Crediticia. The policies implemented by this regulated financiera and by the credit union system stand in stark contrast today, however, as the former institution not only maintained high interest rates paid on deposits throughout the crisis, but it has also been able to pay off virtually all depositors, in a period of one to two years after the onset of the crisis, without any support from the Central Bank or the Government. It suffered from a liquidity (term-structure) problem, not from poor assets. The credit unions, on the other hand, lowered their deposit interest rates and possess portfolios of low-quality assets.

Those credit unions which had maintained a 10 percent voluntary reserve fund with the Federation began to withdraw these funds, in order to honor the withdrawal of their members' savings. This, however, created a serious problem for Fedecrédito, which had in turn lent these funds out, at an average term structure which by far exceeded the sight-deposit nature of the reserves of the credit unions deposited with Fedecrédito. The Federation was then forced to borrow at the National Stock Exchange, at interest rates far exceeding those obtained on the loans made with these funds, and thus seriously jeopardizing Fedecrédito's profitability.

The liability base of the credit unions began to erode, as the members withdrew their deposits and shares, in an effort to salvage their savings. Operational losses kept growing, as well as delinquency in their loan portfolio kept rising. The rapid growth in

delinquency was the result, in part, of the poor quality of the loan portfolio, and, in part, of the members' awareness that the only way to withdraw their savings with the institution was to become delinquent on their loans, since the withdrawal of both shares and deposits had been frozen. When these institutions finally turned to the Federation for assistance, Fedecredito made policy recommendations that were more consistent with the liquidation of these institutions than with their recovery.

Private financial markets were immersed at this time in one of the most serious crises of their history, that had led to a temporary rise in both the level and structure of interest rates. Private financial and non-financial institutions were forced to pay a risk premium four times their historical levels, in order to mobilize resources at the National Stock Exchange. In an effort to reduce the operational losses of the individual credit unions, the Federation recommended, however, that they reduce their financial costs by cutting deposit interest rates in half and by capitalizing between 15 and 50 percent of their deposit liabilities into share accounts. It is important to mention that share deposits have traditionally earned negative or very low returns for the credit union members. Whatever pressures had existed on the part of the depositors to withdraw their savings, therefore, were significantly reinforced by these policies, which implied a partial confiscation of their savings and a rate of return only a fraction of prevailing market rates.

In combination with these policies, the Federation designed a share capitalization plan, which called for the aggressive mobilization of share accounts. The belief was that the savings deposits represented a costly and unstable source of funds and that the credit unions' emphasis should be on the mobilization of share accounts which, because of the

low profitability of the credit unions, earn a rate of return close to zero. The proposed development strategy was for these institutions to withdraw from voluntary deposit mobilization. Credit union members were expected to sign IOU's (pagares), agreeing to deposit in their share account a fixed amount on a monthly basis. As expected, this recovery plan was a complete failure and it only eroded the confidence on the part of the depositors even further. These recommendations only confirmed the poor quality of the technical assistance that the Federation provided to its member credit unions during this difficult period.

One of the important lessons out of this crisis has been a recognition of the concept that share accounts are not capital in the financial sense of the word, that is, equity that would serve to absorb operational losses, protecting the deposit and other liabilities. Because credit union members can withdraw their investment in shares by falling or remaining delinquent on their loans, this means that the true capital in these institutions consists only of grants and retained earnings. The implication of this is that their capital base is inadequate and that reforms must be implemented in order to significantly increase their capital adequacy.

IV. The Federation of Credit Unions

One of the most important structural weaknesses of the credit unions system has been the serious lag in the development of adequate management capabilities, consistent with their asset growth, as reflected by their inadequate response to the recent crisis. With the support of USAID, in 1982 the Federation attracted qualified personnel to manage the institution and as a result it was able to grow quite rapidly. Other agencies,

such as the German Reiffeissen Union, COLAC, the IDB, and the Canadian SIDJ (desjardin) joined AID's effort in helping Fedecredito. Over time, however, the Federation began to be transformed into a revenue-maximizing institution, that did not reflect the objectives of its owners (the credit unions), but that actually developed objectives of its own, at times in contradiction with those of its member cooperatives. Because the department that was supposed to provide technical assistance and training to the credit unions was not a revenue-generating center, its importance declined and it was relegated to a marginal role within the structure of Fedecredito. As a result, the credit unions quickly outgrew their internal administrative capabilities and no institution was in a position to provide the necessary inputs to further develop these capabilities.

With its impressive growth between 1982 and 1987, the Federation was becoming the favorite institution for foreign donor organizations through which to channel financial resources. This access to subsidized foreign loans made domestic savings mobilization increasingly less attractive, given its higher costs and because it taxed the financial management capabilities of the Federation. As claimed in July, 1989 by the General Manager of the Federation, the future strategy of the credit union system would be to mobilize "social capital," in the form of share accounts, from the members to the credit unions and from the credit unions to the Federation. This would allow both the credit unions and the Federation to reduce the cost of funds, while providing the needed capital base to be leveraged with external loans.

The Federation began by capitalizing up to 40 percent of each loan that it granted to its member credit unions. This capitalization was an elegant way of forcing the credit unions to maintain a compensating deposit with zero rate of return for an amount equal

to 40 percent of the value of the loan they were requesting. If the federation charged 28 percent on a loan to the credit union, the effect of the capitalization was to raise the effective rate of interest to 47 percent, because of the compensating balance. These forced savings served as a tax on the member credit unions and could only be withdrawn if the credit union decided to withdraw from the Federation or to become delinquent on their loans.

V. Debt Swap and Credit Union Rescue Plan

In July of 1988, Fedecredito received a grant from the Government of Costa Rica to purchase the charter of the failed Banco de Alajuela. One of the main motivations for the creation of the Banco Federado on the basis of this chart was the fact that the expectations on the part of the credit unions of receiving loans from Bancoop had been frustrated over the years. The agreement signed between Fedecredito, the Government, and USAID, for a donation of 300 million colones for the creation of this bank, is highly restrictive and unrealiztic. It forces Banco Federado to allocate 300 million colones in credit to Fedecredito member cooperatives in just 12 months. When the agreement was reached, most of the major credit unions were facing a serious financial crisis and were not creditworthy. The agreement nevertheless provided Fedecredito with 22 million colones a year to allow it to operate a deposit insurance fund. No technical studies supporting the creation of the insurance fund are available yet.

Because the banking law requires at least ten cooperatives to create a cooperative bank, such as the Banco Federado, Fedecredito distributed 1,000 colones shares to nine credit unions arbitrarily chosen by the federation's staff among all member cooperatives.

Fedecrédito retained the remaining shares of the bank (399.9 million colones). Although the Banco Federado is now in operation, apparently Fedecrédito plans to retain some financial intermediation activities outside this institution. This financial intermediation must be completely separated from the political and representational roles of Fedecrédito in order to avoid some of the institutional problems described in this paper.

In recognition that the metropolitan area market is fairly well covered by the existing financial intermediaries (including some members of Fedecrédito) and that to gain market share in the Capital would be fairly difficult, Banco Federado's strategy is presently focusing on the rural market. Serious questions exist, however, with regard to the degree of competition that this bank will represent for its own member credit unions. The objective so far is to establish bank officer at the same building of the credit unions, offering "complementary" services to those of basic financial intermediation already supplied by the credit unions.

In August 1989, Banco Federado entered into a debt conversion transaction, in representation of Fedecrédito, in an effort to mount a credit union rescue plan. The Banco Federado invested approximately 200 million colones and acquired 513 million colones worth of Central Bank Monetary Stabilization Bonds, at 15 years and with an 18 percent annual rate of interest. The idea has been to have the individual credit unions purchase these bonds from the Banco Federado, at a 40 percent discount on the face value. Fedecrédito would then accept these bonds at face value, in payment of debt and for the Federation to take over the deposit liabilities that the credit unions are not in condition to redeem. The Federation would then replace these credit union deposits with its own certificates. These certificates would carry the same interest rates and term of

the Stabilization Bonds. The plan is to obtain 790 million colones in Central Bank Stabilization Bonds in order to carry out this operation: 290 million for payment of the credit union debt owed to Fedecrédito and 500 million to back the deposit liabilities taken over by Fedecrédito.

Although by substituting Fedecrédito certificates backed by the Stabilization Bonds for credit union liability instruments, the credit union members will recover some portion of their original deposit, the loss that they will sustain will undermine the ability of the credit unions to mobilize deposits in the future. At the recommendation of the Federation, the credit unions have "capitalized" into share accounts between 15 and 50 percent of their deposit liabilities. The Fedecrédito certificates would have maturities of between 10 and 15 years, with a rate of interest of 17 percent. Given present market rates of interest, the depositors will be lucky if they eventually recover 25 percent of the value of their deposits. This reality casts doubts on whether these institutions will ever be able to mobilize voluntary savings again. It appears that the distribution of the capital gains from this financial transaction between the credit union depositors and the Federation is heavily weighted in favor of the latter. It is expected that the Federation will recover 290 million colones of debt which is now of very doubtful quality. Fedecrédito is lobbying to obtain an interest-rate subsidy from the government, as well, in order to make up for the difference between the rate of interest earned on these loans (24 percent) and the rate of interest earned on the Stabilization Bonds.

The feasibility of this operation is still in doubt, however, because the credit unions are supposed to obtain external loans to finance the purchase of the bonds. If the credit unions were to use the limited cash flow that they are currently generating in

order to buy the bonds, the financial viability of these institutions would even be in greater doubt. Fedecrédito has proposed that the loans to be granted to them could come from the following sources, in order to fund the 790 million colones in Stabilization Bonds:

INFOCOOP	100 million
Banco Federado	100 million
Banco Popular	144 million
Total:	344 million

VI. Credit Union Corporation

Several of the problems that the Credit Unions are currently facing have had their origin in the structure and nature of their second-level organization and in the inadequacy of the legal framework that regulates such institutions. Most of these problems are inherent to the current organization of Fedecrédito.² There are significant advantages in a well-designed second-level cooperative institution, nevertheless, advantages related to the pooling of liquidity funds, the reduction of information and transaction costs, and specialization of services are among the most important.

The design of an optimal second-level organization for the Costa Rican credit union movement must take into account the following constraints:

(1) Structural problems inherent to credit union organizations. The proposed organization must prevent the repetition of the mistakes made in the past by

² See Rodrigo Chaves, "Necesidad de una Institución de Segundo Grado para las Cooperativas de Ahorro y Crédito Dominicanas," Rural Financial Markets Program. The Ohio State University, September, 1986.

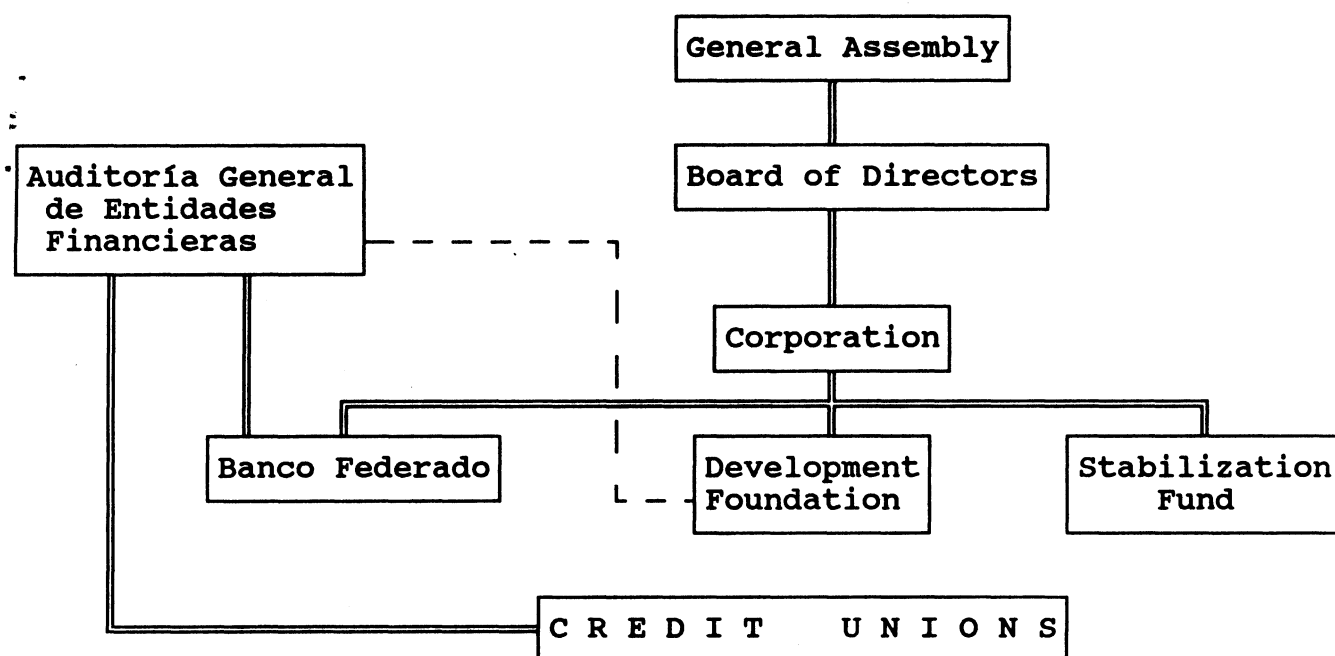
the individual credit unions and their federation. In particular, it is important to stress the political economy problems that arise as consequence of the link between financial decisions, election of directors and executives, and the lack of external supervision and control.

(2) The legal framework that regulates the actions of credit unions and other financial intermediaries. Private commercial banks, for example, are not allowed to issue certificates of deposit with maturity terms of less than 180 days and are required to hold reserves at the Central Bank ranging from 10 to 50 percent of those liabilities. Private banks are also subject to severe Central Bank restrictions on the growth of their credit programs. In contrast, the credit unions and their federation are exempt from these constraints. This provides such institutions with a comparative advantage in savings mobilization.

(3) The ownership by Fedecrédito of the Banco Federado makes it necessary to include this bank into the proposed organizational structure. This institution will make possible the separation of the representational and the financial activities currently undertaken by Fedecrédito. The Banco Federado is also the natural instrument to introduce independent prudential supervision from outside to the second-level credit union structure.

(4) Other circumstances of the present credit union environment, such as the current power struggle between the Banco Federado and Fedecrédito and the situation of some of its members.

Considering the restrictions described above, the optimal operational structure for the Costa Rican credit union system would be the following:



It is felt that this structure would maximize economies of scale, efficiency, and external supervision of the system, given present constraints, while at the same it would fully exploit the comparative advantages of credit unions, given the legal framework that regulates financial intermediaries. This design presents some parallels with the functioning of the credit union movement in the United States. The only legal limitation to the adoption of this structure is that Banco Federado must be a separate entity, although any combination of boards of directors and executives is valid, according to Costa Rican law. It seems a waste of resources (i.e., not to take advantage of economies of scale) to administer each institution separately as it is being currently done. Therefore, it seems advisable that these three institutions share not only their executive staff, but other services such as computer facilities, internal auditing, and all supporting administration services.

(A) DEVELOPMENT FOUNDATION

The Development Foundation would attack three major problems at the individual credit union level. The first and most obvious is the lack of adequate financial and administrative skills of the credit union managers and directors. The Foundation would centralize and implement all the capacitation programs directed at improving the skills necessary to run a credit union. The most relevant training areas are:

- Economic environment and financial strategies.
- Financial trends and competition.
- Accounting and internal control.
- Asset and liability management strategies.
- Composition and cost of funds.
- Liquidity planning.
- Investment strategies.
- Loan evaluation.

The Foundation would become the source of information and technical advice for the member credit unions. It would collect relevant economic information and disseminate it, along with consistent policy advice. This service would greatly increase the affiliates' speed and adequacy of adjustment to their ever changing economic environment. In the United States there exist several institutions that provide similar services for the different sectors of the financial system (e.g., National Credit Union Association, American Banking Association, National Association Community Banks). The Foundation would serve as the system's barometer as well. Its technicians would regularly visit the individual credit unions, in order to evaluate their particular situation and to provide specific recommendations. Such interaction and frequent contact between the Foundation and the credit unions present several advantages. The system would have an "early warning mechanism" for the eventual financial problems of its members,

and the information gathered could be used by the Banco Federado, the stabilization fund, and the Superintendency of Credit Unions.

Another important advantage of this institution is that it already has some significant sources of income. The donation agreement that created Banco Federado stipulates that, after the fifth year beyond the establishment of the bank, Fedecrédito should spend 19.2 million colones a year for technical assistance and training services directed to its affiliates. This amount is 40 percent of the preferred dividends that Banco Federado must pay Fedecrédito on its shares. In 1989 Fedecrédito received a grant from REIFEEISEN UNION of about 50 million colones for the purchase of fixed assets and for pay-roll, to be used by its development department during a period of three years. Finally, the agreement that created Banco Federado provides 22 million colones a year for a deposit insurance system for the credit unions.³ There exists strong evidence that such insurance is neither viable, given the financial position of the major credit unions, nor advisable, because of acute moral hazard problems. Instead, those resources could be used to provide the training and supervision needed by the system, including the funding of the activities of the Superintendency of Credit Unions. Such sources of income should be sufficient to cover the expenses necessary to establish and run the Foundation.

(B) BANCO FEDERADO

Under the proposed design, Banco Federado would assume and centralize all the regular financial intermediation activities of the second-level organization. The bank

³ See Rodrigo Chaves, "Fedecrédito: Oportunidades y Peligros", Rural Finance Program, Ohio State University, Economics and Sociology Occasional Paper No. 1509, October 1988, pp. 50-52.

would be the institution lending for long-term and development purposes to the individual credit unions. The relationship between Banco Federado and the credit unions is not intended to solve the affiliates' short-term liquidity problems, however. Banco Federado should provide credit only to creditworthy credit unions with specific development projects and a good financial position. This would become another source of discipline for the system's members. Banco Federado must be a second-story bank and it should not compete with the individual credit unions for the public's patronizing.

In addition to the obvious benefits from specialization, the centralization of the financial intermediation activities at the Banco Federado would impose restrictions on the Corporation, by introducing external supervision and control into the system. Banco Federado is subject to the regulations and financial standards imposed by the General Superintendency of Financial Intermediaries ("Auditoria General de Entidades Financieras"). The Superintendency examines the quality of the loan portfolio, liquidity ratios, the degree of credit concentration, funding gap, and leverage among others. Such strict control would considerably reduce the political economy problems, discussed earlier, that arise from having the same board of directors make political and financial decisions simultaneously. The ability to use credit as a political instrument would be undermined.

C) THE LIQUIDITY FUND

The liquidity of a credit union depends on the ability of its management to ensure a regular inflow of funds to meet maturing obligations. Due to seasonal and market fluctuations as well as to a variety of reasons beyond the institution's control, some credit unions may need short-term credit in order to meet this demand for funds.

The key role of the stabilization fund is to support the system's liquidity, by moving funds from credit unions where there is a surplus of funds over current demand, to credit unions that have short-term cash deficits. The strength and viability of the system is enhanced by effective liquidity support. Indeed, liquidity support services are indispensable if the credit unions are to function as a system, because the insolvency of one of them imposes a negative externality on the rest. This is so because the traditional credit union customers are not well informed about the financial situation of individual cooperatives and have the tendency to generalize from an individual situation to the remaining institutions. It is most likely, for example, that a transitory cash flow problem in a given credit union would cause a larger-than-average withdrawal of deposits from the others.

The stabilization fund should operate as a mutual fund. It would pool the liquidity reserves of the individual credit unions and would invest these funds in very liquid and secure financial instruments. The advantages of pooling funds are several. Through pooling, a better rate of return should be realized, while at the same time pooling would reduce information and transaction costs for the system as a whole. Access to information and financial investment opportunities is improved with a large organization, because of its status as a large investor, as well as the staff's specialization on financial analysis. The aggregate amount needed for reserves should be proportionately less for the system than it would be required for each individual credit union.

The liquidity fund must be a separate legal entity from the Banco Federado, in order to avoid the Central Bank's reserve requirements as well as restrictions on the term structure of its liabilities. The credit unions would deposit at least ten percent of

their certificates of deposit and demand deposits into the fund. Those resources must be invested in very liquid and secure financial instruments, through the National Stock Exchange the credit unions would have immediate access to their liquidity deposits, whenever their cash flows justify such withdrawal. If a particular credit union had a greater need for cash, it would be eligible for a short-term loan of up to three times its liquidity deposits. It would be the responsibility of the Development Foundation to evaluate the credit union's financial position and the nature of its cash flow problem. The Development Foundation would also provide sound financial advice in order to solve this liquidity problem.

The stabilization fund could function on a budget basis. That is, at the beginning of the year, the Corporation would estimate the expenses necessary to run this activity and would then subtract that amount from the interest income generated by the fund. The fund's remaining revenue would be distributed among the credit unions every three or six months. About two to three employees would be required to run the fund. It is expected that once those expenses have been subtracted, the yield that the credit unions would get on their liquidity reserves would be greater than the yields they would get if they had invested the funds individually.

VII. REGULATORY FRAMEWORK

There exists agreement on the part of all sectors involved that one of the most important causes of the system's current crisis is the lack of external supervision and prudential control. The system has never had an effective regulatory mechanism to supervise the financial activities of these institutions.

Since credit unions are regulated by the Cooperative Law, the Auditoría General de Entidades Financieras is not responsible for their supervision. INFOCOOP is the state agency that is charged with the regulation of all cooperative organizations. It has never had neither the internal capacity to supervise the financial activities of the credit unions nor the political willingness to regulate the system, however this unwillingness arises from the fact that 4 out of 7 of INFOCOOP's directors are representatives of the cooperative movement. These 4 "cooperative" directors do not have incentives to regulate and supervise the movement they represent.

It is obvious that the optimal solution to this problem would be to change the current legal framework, in order to provide the Auditoría General de Entidades Financieras with the authority to supervise and take legal action against any credit union that is jeopardizing the value of its members's savings. According to a senior partner of the legal firm ASELEX, there exists political willingness, specially in the Executive branch, to implement such reforms. This would be achieved by introducing several amendments or even a bill for a new cooperative law during the Legislative Assembly's extraordinary meetings (February-May).

It is also the opinion of this lawyer, that a short-term solution to this problem may come from a particular interpretation of Law No. 7107 (Ley de Modernización Financiera), especially its articles No. 124 and No. 131. Article No.131, item #4, states that it is in the authority of the Auditor General to decide which entities, different from banks and financieras, are subject to the Auditoría's supervision. On the other hand, Article No. 124 excludes from the Auditoría's jurisdiction all those intermediaries that are currently being regulated by special laws. According to this lawyer, it would be enough to demonstrate that credit unions are not actually being regulated by

INFOCOOP, in order to place these institutions under the Auditoría's scope of action. The reason why the Auditor General would be able to make this unilateral decision is that INCOOP regulates credit unions as "cooperatives" but not as "financial intermediaries." Regardless of the course of action chosen in order to give the Auditoría General jurisdiction over the credit unions, which might even be INFOCOOP's delegation of these functions, there still exists a financial constraint. The Auditoría would have to supervise a large number of new institutions. This not only raises questions about the Auditoría's ability to handle the additional work, but it would actually be necessary to hire new employees. These expenses may be covered with the 22 million colones a year that Fedecredito receives from Banco Federado as preferred dividends. This mechanism would make credit union supervision more attractive to the Auditoría General.

Given the importance that effective prudential supervision has on the financial stability of the credit union system, the process of introducing an amendment to the Cooperative Law has already been initiated, with technical assistance from the Ohio State University. The bill would provide the Auditoría General de Entidades Financieras with the legal ability to supervise the financial activities of the credit unions. As requested by Dr. Carlos Sáenz (Presidential Advisor, Chairman of Fosecoop, and member of the Central Bank's Board of Directors), a legal expert will draft a credit union chapter to be incorporated into the current Cooperative Law.

It is important to indicate that Fedecredito, the individual credit unions, INFOCOOP, the Presidential Advisor, and the Central Bank all agree on the importance of such legal reform. The Central Bank and the Auditoría claim, however, that the latter would need some financial support to undertake the new responsibility.

This legal reform would result from the following time table and lobbying process:

- A) The credit union chapter of the Cooperative Law would be completed at the beginning of December, 1989. It would be reviewed by experts from the Ohio State University during the rest of that month.
- B) The new bill would be distributed to the interested groups by the end of December. Lobbying activities in favor of this legal change would take place through February.
- C) The bill would be approved by the Legislative Assembly in its extraordinary sessions (February - May, 1990).

The lobbying should take place at 2 levels. First, at the Executive Branch, because the Central Government sets the agenda for the Legislative Assembly during its extraordinary sessions. It is important to convince INFOCOOP, the Central Bank, and the Casa Presidencial to make sure that the desired legal reforms will be part of the agenda of the Legislative for that period. Second, it would be necessary to convince some key PUSC and PLN legislators, in particular:

PUSC

Luis Manuel Chacón

Oscar Avila

Rodrigo Araya

Juan Luis Delgado

PLN

Alberto Fait

Rosemary Karpsinski

Mario Carvajal

José Miguel Corrales

It is felt that if these legislators agree with the reform, it will be easily approved. It is important to make sure that the right amount of supervision and control is exerted on the credit unions. Too much regulation could be as damaging as no regulation at all.

